# INVESTMENT-BASED SOCIAL SECURITY[*]

by

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If allowed to run its course, the exploding cost of Social Security is destined to become the greatest financial crisis in American history. The unfunded liability of the nation's largest entitlement program is twice the national debt, and if Social Security solvency is preserved simply by raising taxes and cutting benefits, the cost will exceed the combined cost of all the wars fought in our nation's history. The looming Social Security crisis is more than a financial crisis, it is a human tragedy which will force us to choose between economic opportunity for our children and retirement security for our parents.

The limit on benefit reduction imposed by the social fabric of the nation and the limit on payroll taxes imposed by the economic reality of a competitive world economy render benefit reductions and tax increases inadequate to meet the challenge. The solution lies instead in transforming our debt-based Social Security system into an investment-based system. We must take the best features of our current Social Security system and combine them with the

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time-tested principles of private saving and investment. In doing so we can produce a secure system that will provide benefits not only to our parents but to our children as well. In fact, investment-based Social Security achieves what Americans thought Social Security did all along -- it helps us save during our working years to provide for our retirement years.

The Social Security Crisis

The imminent crisis in Social Security is best described by looking at the number of workers per retiree and how much each worker must pay in taxes to fund Social Security benefits. In 1937, 42 workers contributed two percent of their first $3,000 of wages to pay benefits for one retiree. By 1965, there were fewer workers per retiree and the burden was higher, with four workers each being taxed 7.25 percent of the first $4,800 of wages to provide benefits for one retiree. Today there are just 3.3 workers paying 12.4 percent of the first $68,400 of wages to take care of each retiree. By 2030, according to the 1998 Social Security Trustee's Report, two workers will each have to pay 16.6 percent of the current law wage base to fund Social Security benefits for a single retiree. As the payroll tax spirals, the economic opportunity of children and grandchildren will be pitted against the financial security of their parents and grandparents and everyone will lose.

<u>What Caused the Crisis?</u>

To understand how the current crisis in Social Security came about, it is helpful to look at the history of the transfer payment entitlement. Transfer payment funding of entitlements started in Germany in 1889 with a dramatic new program initiated by Chancellor Otto von Bismarck. While cloaking his program in the language of saving and investment, Bismarck taxed current workers to pay benefits to current retirees. The next generation would then be taxed to provide benefits for those now working. Bismarck's system substituted a tax on the future earnings of unborn workers for the traditional system of saving and investment.

The transfer payment funded entitlement has become the dominant social program in the world. The Bismarck system first spread throughout Europe and reached Australia in 1909. It came to the Americas in 1925 when Chile adopted the system. It arrived in the United States in the form of Social Security in 1935 and Medicare in 1965.

All of the world's entitlement programs that rely on transfer payment funding have two problems in common:

> 1) They do not create any wealth, and they do not enjoy the miracle of growth through the enormous power of compound interest.

2) All transfer payment programs are held hostage to demographics. The remarkable increase in life expectancy and the collapse in the birth rate have driven down the ratio of workers to retirees and driven up the cost that transfer payments impose on workers. These trends, which have dominated the last third of the 20th century, show no signs of abating in the 21st century.

These problems are illustrated in America's experience with the Baby Boom generation. There are 77 million people in America who were born between January 1, 1946 and December 31, 1964. That generation and the explosion in the work force it produced made Medicare possible and sustained Social Security far longer than the system could have survived without it.

Baby Boomers, now at the peak of their earning power, are paying 60 percent of the total payroll taxes now collected in America. In 30 years, that figure will have dropped to less than two percent and the newly retired Baby Boomers will be demanding benefits the current system is incapable of providing. In the 20 years after the Baby Boom generation starts to retire, the retirement rolls will grow almost four and a half times as fast as the employment rolls.
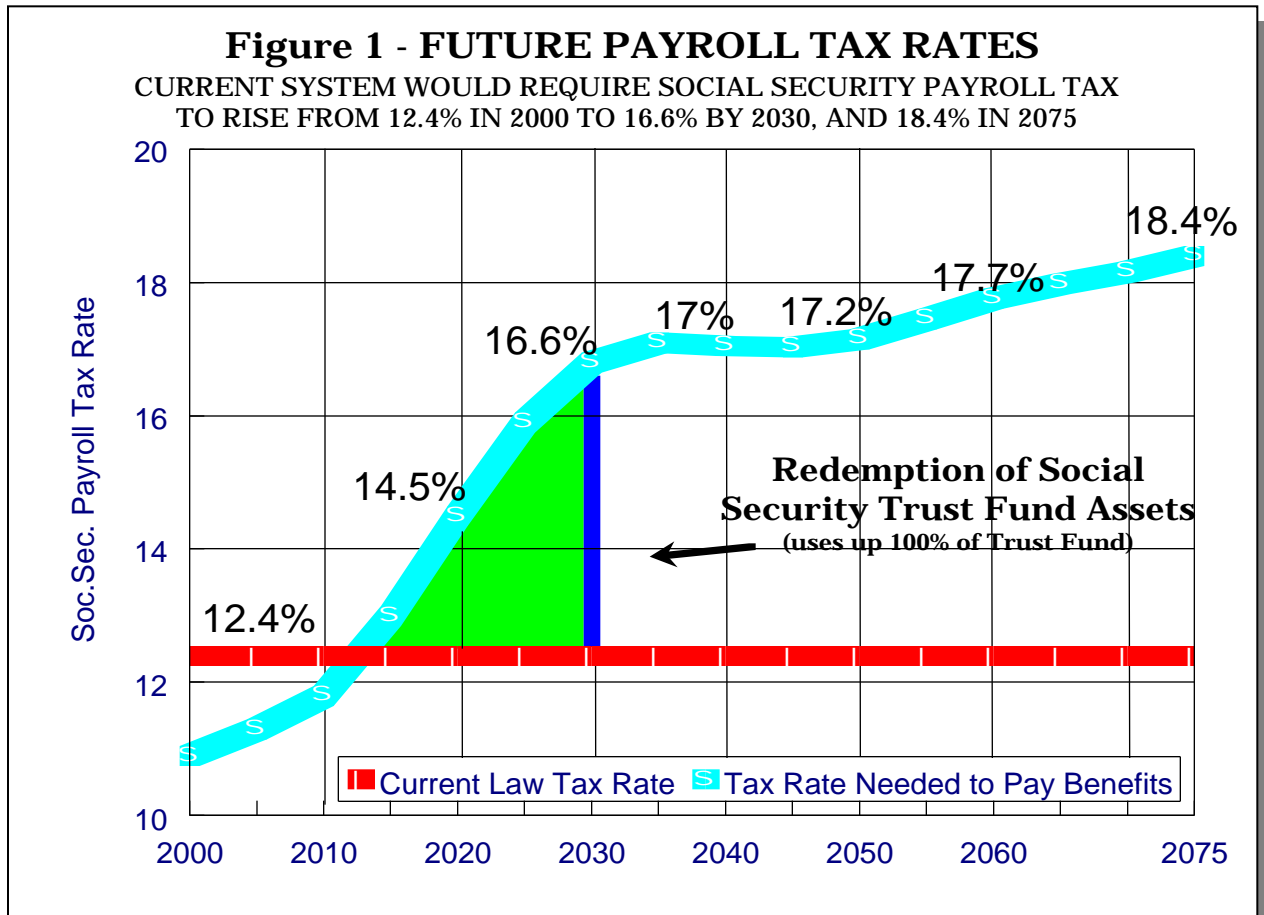
<u>The Status Quo</u>

In 1935, when the United States Congress passed the Social Security Act, the debate was laced with references to the traditional practice of saving during one's working years to fund benefits in retirement.  Americans were told that they would pay into the Social Security system to build up an investment fund that would be used to finance their benefits in retirement.  Senator Pat Harrison of Mississippi, Chairman of the Committee on Finance, which wrote the legislation, said that, "Besides the saving to the Nation as a whole, the annuity system will give to the worker the satisfaction of knowing that he himself is providing for his old age."

Unfortunately, the legislation establishing Social Security never matched the rhetoric of the politicians who sold it.  No investments were ever made.  No wealth was ever created.  No interest was ever earned.

Today, none of the taxes paid into the Social Security system are set aside to pay future retirement benefits to the worker whose paycheck is being reduced.  Most of the money is used to provide benefits for today's retirees.  The remainder is taken by the Federal government and spent on other, totally unrelated programs.  In fact, the Federal budget is expected to be in a technical surplus in 1998 only because the portion of Social Security taxes not used to pay for today's retiree benefits, $104 billion, more than offsets the $41 billion of deficit spending on other programs of the Federal government.

<u>Projection of the Status Quo</u>

As shown in Figure 1, the existing Social Security retirement system will require huge tax hikes in order to pay the benefits currently promised to the elderly. By 2013, Social Security will spend more each year than it takes in. In order to pay promised benefits, Congress will

**Figure 1 - FUTURE PAYROLL TAX RATES**

CURRENT SYSTEM WOULD REQUIRE SOCIAL SECURITY PAYROLL TAX
TO RISE FROM 12.4% IN 2000 TO 16.6% BY 2030, AND 18.4% IN 2075

Soc.Sec. Payroll Tax Rate

18.4%

17.7%

17% 17.2%

16.6%

14.5%

**Redemption of Social Security Trust Fund Assets**
**(uses up 100% of Trust Fund)**

12.4%

■ Current Law Tax Rate ⑤ Tax Rate Needed to Pay Benefits

2000  2010  2020  2030  2040  2050  2060  2075

be reduced to two options. It can begin to raise payroll taxes, or, for a short while, Congress can "cash-in" the IOUs which the government owes the Social Security Trust Fund.

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The current Social Security surplus has been accumulating since Congress reformed the system to prevent bankruptcy in 1983. By 2013 the Trust Fund surplus is projected to be $3.032 trillion. But, in reality, the annual surplus of Social Security taxes over Social Security benefit payments has been used to fund other programs of the Federal government. The surplus simply made it possible for the Federal government to spend more, tax less and borrow less each year the Social Security surplus existed than would have been the case in the absence of the surplus. The Trust Fund is a notional bookkeeping device which is not counted as an external debt of the Treasury, and when notional interest payments are made to the Trust Fund, they do not count as outlays of the Federal government. The existence of the notional surplus in no way provides any resources to enable the Federal government to pay Social Security benefits in the future. To pay benefits at levels above the level of Social Security taxes paid in, the Federal government must do all the things it would be required to do if there were no Social Security IOUs: raise taxes, cut other spending or borrow from the public.

By 2013 the Social Security system will be unable to pay promised benefits at the existing payroll tax rate of 12.4 percent. Only by "redeeming" the entire Social Security Trust Fund and forcing the Federal government to cut other government programs, raise other taxes, or borrow from the public can a payroll tax increase be forestalled. But this strategy would only delay the payroll tax hikes until 2032 when the Trust Fund IOUs would be exhausted. If the current Social Security system is left unchanged, sooner or later the payroll tax rate will have to rise -- and the hikes will be huge. The payroll tax rate will rise from 12.4 percent to 16.6

percent by 2032 and to 18.4 percent by 2075.  When combined with rising Medicare costs, the payroll tax could double over the next 30 years.

The equally unpalatable alternative to the confiscatory payroll taxes shown in Figure 1 is to cut benefits.  To maintain Social Security solvency after 2032 requires a 25 percent reduction in benefits.  Seventy-five year solvency requires a 33 percent reduction in aggregate benefit levels.  If unchanged, Social Security's current structure ultimately will force us to choose between massive tax increases that erode economic opportunity for our children, and staggering benefit cuts which destroy our parents' retirement security.

Finding A Solution

If the levels of benefit cuts and tax increases required to maintain the current debt-based system are not feasible, is there an alternative?  The answer is yes.  Here is why:

> 1) If three percentage points of the current 12.4 percent payroll tax paid by a 22-year-old worker were annually invested in real assets, stocks and bonds for the remainder of his working life, the value of just that three percent real investment would roughly equal the Social Security benefits a 22-year-old worker is currently promised by the Social Security.

2) The estimated average annual federal budget surplus over the next decade --
$215 billion – will more than pay for the annual transition cost of allowing
workers to opt into an investment-based Social Security System.

3) An investment-based solution to the Social Security crisis has already been
tested, and it works.  More than half a dozen countries have already discarded
the Bismarck system and replaced it in total or in part with an investment-based
system.  Australia did it under a left-leaning labor government, Britain did it
under Margaret Thatcher, and Chile did it as a developing country. In each
case, benefits have become more secure and average retirement incomes have
risen.

Converting Taxes Into Investments

To initiate an investment-based Social Security system, every American worker would be
given a choice of staying in the current system or becoming part of the new investment-based
system, but participation in one or the other would be mandatory.  Workers who choose to
enter the investment-based system will be guaranteed a benefit upon retirement which can
never be smaller than what they would have received under the current Social Security
system plus 20 percent of the value of the Social Security investment they build up over their
working lives.

Those who choose to move from the current debt-based system of Social Security into the new investment-based system would continue to have 12.4 percent of their wages withheld by their employer.  Just as under the current system, the employee will pay half of the withheld amount directly out of wages and half indirectly through the employer's contributions.  But for those opting into the new system, three percentage points of that 12.4 percent deduction would not go to pay benefits for current retirees, or to fund general government, but instead would be invested in real, earning assets. Each worker would own his new investment account, which would be used solely for the purpose of paying his retirement or survivor benefits.

For the purpose of this analysis, the expected rate of return on investment is calculated by throwing out the high rates of return of the last five years as an aberration.  While the rate of return on investments in common stock is off sharply over the last six months, the Dow Jones Industrial Average would have to fall another 3,700 points to bring returns over the last five years down to the average of the previous 67 years.[1]  The analysis which follows uses the average rate of return for the previous 67 years (including the Great Depression) on the Standard and Poors (S&P) stock indices, on an index of the 20 percent of companies listed on the major stock exchanges with the smallest capitalization, and on the Salomon Brothers Long-Term High-Grade Corporate Bond Index.
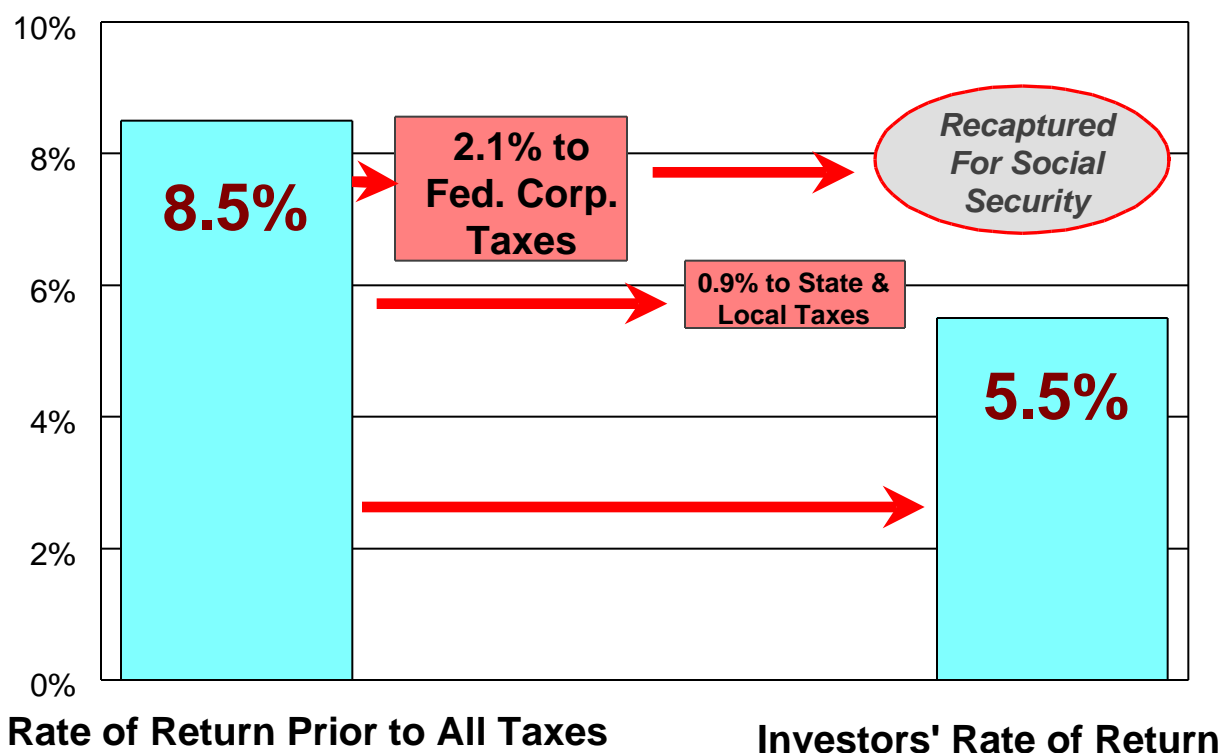
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[1] This calculation is based on the Dow Jones Industrial Average closing value of 8,089 on September 16, 1998.

This analysis is based on estimates by Harvard economist Martin Feldstein and Dartmouth economist Andrew Samwick at the National Bureau of Economic Research.    Figure 2 summarizes the historical rate of return found by Feldstein and Samwick for an investment portfolio consisting of 60 percent stocks (40 percent in the S&P Index and 20 percent in small company stocks) and 40 percent bonds.  Looking at data from 1925 through 1992 Feldstein

## Figure 2 - Average Rate of Return on 60:40 Investment

Gross Return of 8.5% becomes 5.5% after Corporate Income Taxes

**8.5%**

**2.1% to Fed. Corp. Taxes**

*Recaptured For Social Security*

**0.9% to State & Local Taxes**

**5.5%**

**Rate of Return Prior to All Taxes**

**Investors' Rate of Return**

and Samwick found that the before tax rate of return was 8.5 percent in real, after inflation, dollars.  No investor ever saw this 8.5 percent real rate of return, however, since 24.7 percent or 2.1 percentage points was lost to Federal corporate income taxes and 10.6 percent or 0.9

percentage points was lost to state and local taxes.  The rate of return actually received by the investor was 5.5 percent.[2]

While Feldstein and Samwick argue that it would be desirable to exempt Social Security investments from the Federal corporate income tax to give investors the full benefit of their investment income, there is no practical way of giving differential tax treatment to the portion of corporations which would be owned by Social Security accounts.   It is conceptually possible, however, to earmark for the Social Security system a conservative estimate of those Federal corporate income taxes collected solely on the earnings of individual Social Security investment accounts.  Through a process we will call recapture, the tax revenues would be collected by the Treasury and remitted to the Social Security system, just as taxes on existing Social Security benefits are now earmarked for Social Security.

In the analysis which follows, a recapture rate is established based on the assumption that 80 percent of the funds going into Social Security investment accounts would be net additions to national investment (20 percent would be offset by reductions in other forms of savings and investment).[3]  It is further assumed that 10 percent of the Social Security investment funds would be invested abroad and therefore would not pay U.S. corporate taxes and that 5

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[2]   See Martin S. Feldstein and Andrew A. Samwick "The Economics of Prefunding Social Security and Medicare Benefits" working paper 6055, National Bureau of Economic Research, Cambridge, MA, pages 8 and 9.

[3]   As will be shown in Figure 4, it will take almost 50 years for the build up of individual investment accounts to yield a retirement benefit 20 percent above the level promised by the existing Social Security system.  It therefore would seem improbable that workers who enter the investment-based system would reduce other savings by more than 20 percent in response to the build up of wealth in their individual Social Security investment accounts.

percent of the investments would escape corporate taxes (subchapter S corporations taxed as individuals, for example).

These assumptions would reduce the effective Federal corporate tax rate recapture to 23.9 percent, down from the statutory level of 35 percent. In each year the level of Federal corporate taxes collected on Social Security investment would be estimated by taking the actual returns earned by Social Security investment accounts and multiplying the dollar value of those returns times 23.9 percent. At the end of each fiscal year this estimated amount would be transferred by the Treasury to the Social Security system. The recapture would apply only to the new investment occurring in the economy as a result of investment-based Social Security and would not significantly alter the amount of corporate taxes that would have been collected in the absence of an investment-based system.

While total return on the investment portfolio is assumed to average 5.5 percent, as has been the historic norm, part of this return must be used to cover the administrative costs of managing the individual accounts. Many actively managed mutual funds have administrative loads as high as one percent of assets, but since funds set aside for investment-based Social Security will be held for long periods of time, a more appropriate model for estimating administrative costs would be the Thrift Savings Plan (TSP), which manages retirement funds for federal workers, or privately managed index funds such as the Vanguard Index 500 Fund or the Fidelity Spartan U.S. Equity Index Fund. The TSP funds

carry an average administrative cost of 0.09 percent, or nine basis points, while the privately managed index funds average 0.19 percent, or 19 basis points.

Under an investment-based Social Security system, fund managers would be required to assess the same percentage administrative charge on all investors, regardless of account size. This would result in low-income workers receiving an implicit subsidy from high-income workers, since certain fixed costs would apply to every account. Given these factors, the economic model used in this analysis assumes that investment-based Social Security accounts would have an average administrative cost of 0.2 percent, or 20 basis points, lowering the net total return on the accounts to 5.3 percent per year.[4]

Individual Ownership and Control of Investments

If every working American chooses to move into the investment-based system, the total three percent investment would average $137 billion a year over the first ten years of the program, an amount well below the projected average annual surplus in the federal budget from 2000 to 2009. In the transition plan outlined below, a portion of the budget surplus would be directed to the Social Security Trust Fund to replace the three percent of wages that would be invested in investment-based Social Security accounts.

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[4] It is probable that funds managing Social Security investments would initially lose money while investment accounts are small but become profitable as investment accounts build up. If a maximum management fee were established by the Social Security system, it would eliminate direct selling and active management of Social Security investment accounts.

Unlike the current Social Security system, the investments funded by the three percent contributions would be owned by the individuals who made them. These worker-owned accounts would be called <u>Social Security Individual Investment Accounts or SI Accounts</u>.

Like today's Individual Retirement Accounts, the SI Accounts would be owned by the individual employee, with rights of property enforceable in the courts. No politician could ever touch the SI Accounts. No government interference would be permitted in directing or controlling investment decisions, other than the general guidelines established for safety and soundness purposes. This is a level of security totally absent under the current debt-based system. In <u>Nestor v. Fleming</u> (1960) the Supreme Court ruled that individuals have no right to Social Security benefits based on the taxes they have paid. Workers have a legal right only to what Congress chooses to give them, and the level of Social Security benefits in the future is no more secure than the willingness of Congresses not yet elected to raise taxes to pay for them.

The SI Accounts would be managed by private sector businesses called <u>Qualified Social Security Individual Investment Funds (Qualified SI Funds)</u>. Qualified SI Funds would be certified by the federal government as meeting rigorous financial and operating standards. The individual workers would choose the specific Qualified SI Fund that would manage their SI Account, just as workers today choose where to place their IRAs. Qualified SI Funds

would compete based on rate of return, customer service, commissions charged and guarantees provided.

The Qualified SI Funds would invest the assets of the SI Account in stocks, bonds, bank deposits, insurance instruments, annuities, and other earning assets, within strict safety and soundness parameters set by federal regulators. The only direct involvement of the worker in choosing the actual investments made with his money would be embodied in his choice of a Qualified SI Fund to manage his investments.

There would be an entry on participating workers' paycheck stubs that would show exactly how much money was invested in their SI Account for that pay period. At least once per year, the Qualified SI Fund, which manages the employee's investment, would be required to provide a Social Security Investment Status Report to every participant. The Social Security Investment Status Report will show investments made over the last quarter, the last 12 months and during the life of the SI Account, as well as the rate of return earned over each period. The SI Status Report would also provide a projection of how much the worker would have available at retirement if contributions and earnings continue at the same rate during the remainder of his working years. Earning rates achieved by all qualified SI funds will be made public quarterly, and each worker would have a right once a year to switch his SI Account from one Qualified SI Fund to another.

## Safety and Soundness Protections

In the investment-based system, workers are assured that their retirement is built upon the actual investment of their savings, in their own name, in genuine earning assets, rather than relying upon government actions taken by a future Congress in another generation. Any action by government to take SI Account funds would be blocked by the Takings Clause of the Constitution.

Oversight and regulation of SI Accounts and SI Funds that manage them would be the responsibility of a newly created Social Security Investment Board (SI Board). The membership of this Board would include the Secretary of the Treasury, the Chairman of the Federal Reserve Board, the Chairman of the Securities and Exchange Commission, and two members from the private sector. One of the private sector members would serve as Chairman of the SI Board. The two private sector members would be appointed by the President, and confirmed by the Senate to serve for staggered terms of six years. They would be experts in finance, investments or insurance.

The SI Board would have several key responsibilities. The Board would establish the safety and soundness standards under which all SI Funds would be regulated and would certify those companies that qualify to sell SI Accounts by meeting the standards established by the Board. Furthermore, the SI Board would have the power to assess penalties, including

decertification, against any SI Fund that the Board determined to be in violation of SI Board standards.

Additionally, the Board would be responsible for establishing the parameters for sound diversification of investments. Initially SI Accounts by law could hold no more than 60 percent of their investment portfolio in stocks, with no more than three percent of the portfolio invested in the stock of any one company. After two years, the SI Board could change that ratio to allow greater levels of equity investment for younger workers and smaller risk exposure for workers nearing retirement. The SI Board could set general parameters for the investment portfolio but would be strictly prohibited from in any way directing the selection of the actual investments made by SI Funds.

The SI Board would coordinate the examination activities of the existing federal regulatory agencies that would assume responsibility for direct oversight of the various financial institutions certified to serve as Qualified SI Funds. Actual examination of the SI Funds for compliance with safety and soundness standards would be conducted by the agency that specifically chartered the institution serving as an SI Fund and which supervised its other activities.

For example, in order to ensure compliance with the standards and rules established by the SI Board, the Securities and Exchange Commission, which now has direct examination and supervisory responsibility for mutual funds and other investment companies, would directly

examine and supervise the mutual funds and investment companies that become Qualified SI Funds and manage SI Accounts. Similarly, the bank regulators, such as the Comptroller of the Currency, state banking authorities, the Federal Reserve Board, and the Federal Deposit Insurance Corporation, would have the responsibility for monitoring the activity of any banks under their supervision that offer SI Accounts.

Transition Retirement Income

The workers who choose to participate in the new, investment-based Social Security system and open SI Accounts would, upon reaching retirement age, be required first to use their investment funds to buy a Social Security Individual Investment Annuity (SI Annuity).

To qualify as an SI Annuity, an annuity would have to provide a monthly income that is guaranteed for the remainder of the retiree's life and be protected against inflation.[5] The SI Board would set standards for SI Annuities which their sellers would be required to meet.

When the investment-based system is fully phased in, each retiree will be required to purchase an SI Annuity that provides a monthly payment equal to the current Social Security benefit plus 20 percent. Any funds in the retiree's SI Account above the amount required to purchase an SI Annuity paying the current Social Security benefit plus 20 percent (and
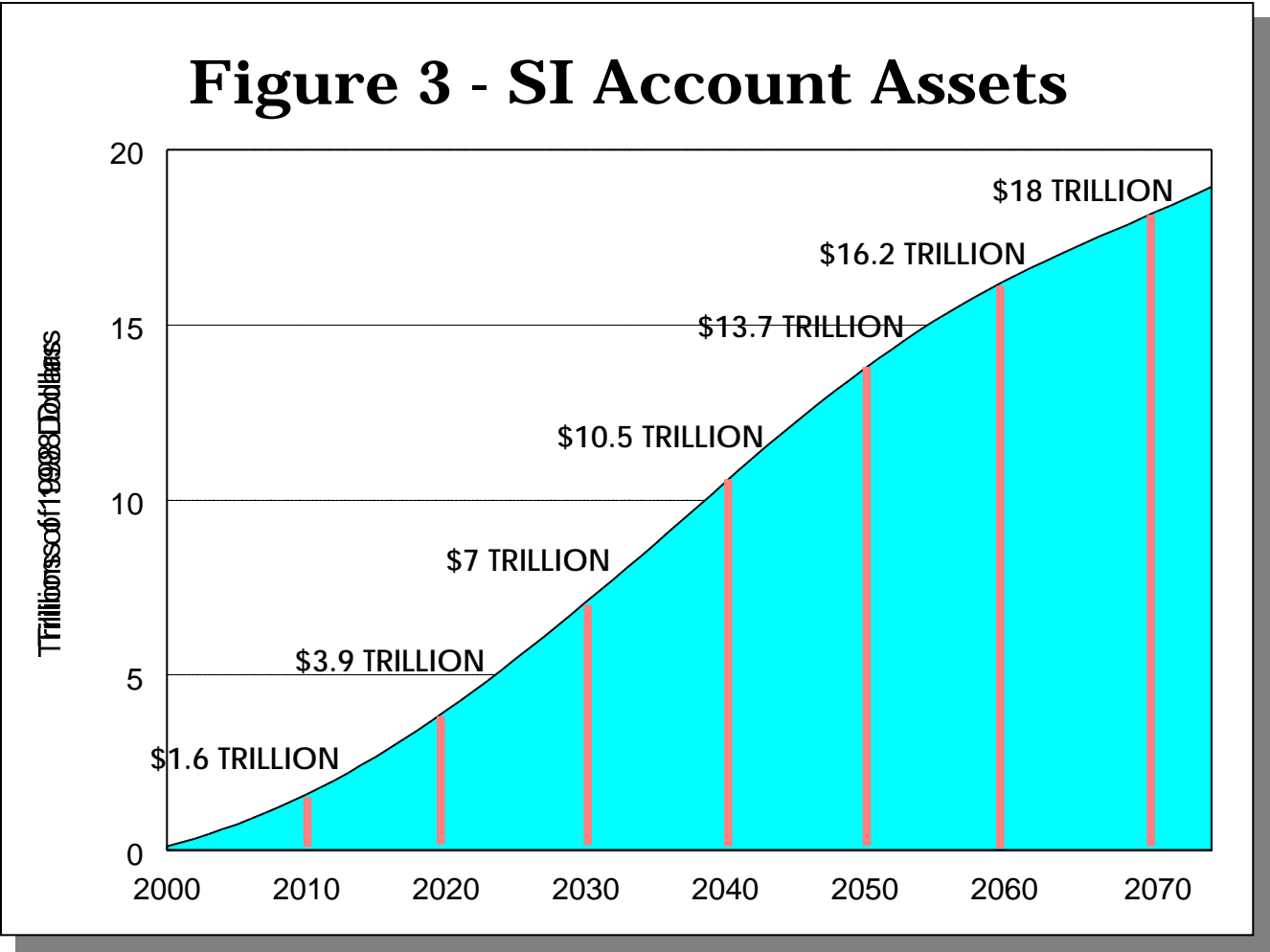
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[5] The annuitization of the SI Accounts is based on the assumption that the investments earn returns in the annuity similar to those received in the SI Accounts. The cost of annuitization could be reduced if the Federal government were required to pay any cost of living adjustments above three percent.

survivor benefits to be discussed later in this analysis) could be withdrawn by the retiree in total or in part and be used for any purpose.

The gains that would accrue to the SI Account over the life of the investment would not be subject to taxation until the employee retired.   The income received from the SI Annuity would be treated for tax purposes in an identical fashion to income received from the current Social Security system.  Any funds in an SI Account not used to purchase the required SI Annuity or pay for other current law benefits would be taxed as  investment income.

On January 1st of the year 2000 every worker holding a Social Security card will be given a choice.  They can enter the investment-based system or they can stay in the current Social

## Figure 3 - SI Account Assets



$18 TRILLION

$16.2 TRILLION

$13.7 TRILLION

$10.5 TRILLION

$7 TRILLION

$3.9 TRILLION

$1.6 TRILLION

Trillions of 1998 Dollars

20

15

10

5

0

2000    2010    2020    2030    2040    2050    2060    2070

Security system.  Those acquiring a Social Security card after January 1$^{st}$ of the year 2000 will automatically enter the new investment-based system.  Those entering the new investment-based Social Security system will be guaranteed retirement, survivor, disability and other benefits at least equal to those provided by the current Social Security system.  Those not choosing to enter the investment-based system on January 1$^{st}$ of the year 2000 can exercise the choice to enter the new system at any point during their working lives.

Under these rules, over a fairly short period of time it seems highly probable that virtually every worker would opt into the investment-based system.  Figure 3 shows the build up of investment assets, net of retirement benefits paid, assuming all workers participate in the new program.  The aggregate level of SI Accounts begins at zero in 2000 and grows to $1.6 trillion in just 10 years.  The amount of assets builds up at an accelerating rate, reaching $10.5 trillion in 2040 and growing at a slower rate thereafter.  The data on which Figure 3 and all other Figures in this analysis is based is presented in Tables 1 and 2.

To understand the transition process, consider a 20-year-old worker who began in the year 2000 to invest three percentage points of his 12.4 percent payroll tax in an SI Account. Suppose for simplicity that the worker's wages over his working life average $30,000 a year, adjusted for inflation.  Based on historic rates of return, if the Qualified SI Funds managing the account had a 60/40 mix of stocks and bonds, the worker could expect a net average annual real rate of return of 5.3 percent, net of management fees.

When the 20-year-old worker reaches 67[6], his SI Account would be valued at $175,372 allowing him to purchase a Social Security Annuity that would pay $15,486 annually, which is 23 percent more than the $12,585 the current Social Security system would have provided.[7]

During the transition period, those workers who are older when they join the new system would have a shorter period of time to invest before reaching retirement age. As a result, there would be insufficient funds in their SI Account alone to fully fund their retirement. In such cases, the worker will draw retirement benefits in part from the existing Social Security system and in part from his own SI Annuity.

For example, a 45-year-old worker who joined the investment-based system in 2000 and who also had real average earnings of $30,000 would build up an SI Account of $33,249, large enough to purchase an annuity of only $2,936 per year. The 45-year-old worker is promised $12,585 a year of benefits under the existing Social Security system. In addition, he was guaranteed when he entered the investment-based system that he would never receive less than what he would have received under the old system plus 20 percent of the SI Account investment he builds up over his working life. Under the transition plan, the 45-year-old worker, therefore, would receive an annual retirement of $13,074. The extra $489 is the worker's bonus which equals 20 percent of the amount of retirement benefits funded by his investment annuity. The investment annuity pays the $489 bonus and replaces $2,447 of tax-

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[6] Under current law the retirement age will begin to rise in 2003 and reach 67 in 2027.

[7] Unless otherwise stated, all figures are in inflation-adjusted dollars.

funded benefits.  The 45-year-old worker upon retirement would, therefore, receive $2,936 per year from his SI Annuity and $10,138 per year from the existing Social Security system.
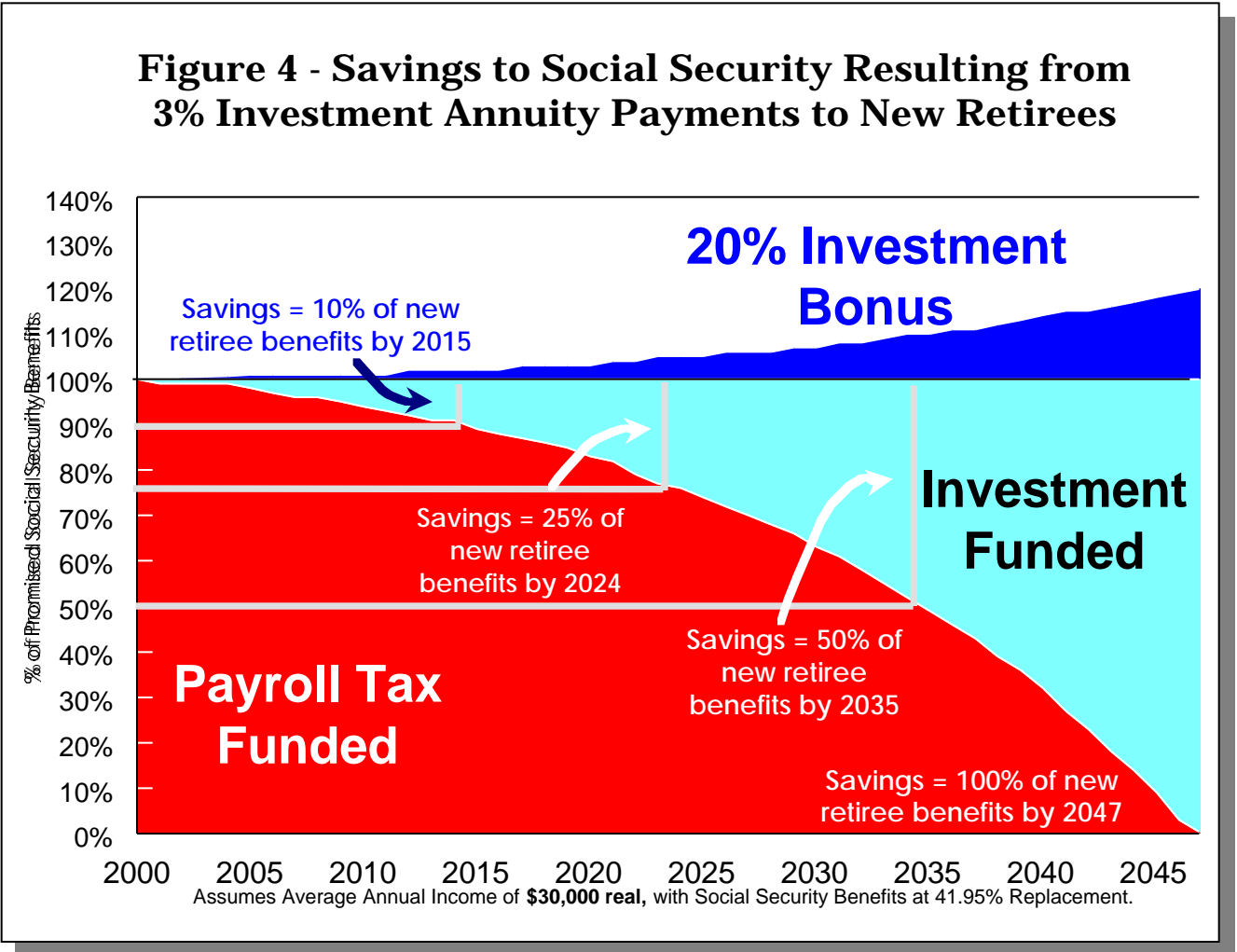
If a young worker enters the labor force after the year 2000 and, due to low wages or unemployment builds up an SI Account insufficient to pay the promised benefit of 20 percent of his SI Annuity plus the current Social Security payment, the Social Security system will supplement his SI Annuity by the amount required to provide the guaranteed benefit.  The same guarantee would apply to any worker whose SI Account earnings are insufficient to pay the 20 percent bonus and the benefit that could be expected under the existing Social Security system.

Compound Interest and Investment Growth

With each year that passes after the new investment-based system is established in 2000, new retirees will get an increasing share of their retirement income from their SI Annuities rather than from the existing Social Security system.  Figure 4 shows how the percentage of Social Security benefits paid for by the payroll tax declines as the level of investment rises.  The numbers in Figure 4 are based on an average worker who earns $30,000 a year in inflation-adjusted dollars.  Figure 4 shows that the value of the SI Annuity which a new retiree can purchase with his SI Account rises to an ever-increasing percentage of the

promised Social Security benefit as the length of time the worker pays into his SI Account increases.[8]

As shown in Figure 4, those retiring in 2000 will have built up no investments and their Social Security benefits will be paid for entirely out of the existing Social Security system by

## Figure 4 - Savings to Social Security Resulting from 3% Investment Annuity Payments to New Retirees

**20% Investment Bonus**

Savings = 10% of new retiree benefits by 2015

Savings = 25% of new retiree benefits by 2024

**Investment Funded**

Savings = 50% of new retiree benefits by 2035

**Payroll Tax Funded**

Savings = 100% of new retiree benefits by 2047

Assumes Average Annual Income of **$30,000 real,** with Social Security Benefits at 41.95% Replacement.

payroll taxes. Each year SI investments will grow and displace an ever increasing portion of payroll taxes dedicated to funding Social Security benefits. The worker retiring in 2015 will have built up an SI Account which will displace 10 percent of the Social Security benefit that

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[8]  See Tables 1 and 2 at the end.

would have been funded by payroll taxes and fund a two percent bonus above the total level of Social Security benefits that he would have received under the existing Social Security system. The 10 percent funded by the SI Account instead of payroll taxes is permanent and never again will workers have to pay a payroll tax to fund that portion of Social Security benefits for those retiring in 2015.

By 2024 the average worker earning $30,000 will have built up investments large enough to pay the 20 percent investment bonus to the worker which will equal five percent more than his expected Social Security benefit and still displace 25 percent of the cost previously borne by the payroll tax. By 2035 the SI Account funds a bonus equal to 10 percent of the Social Security benefit provided by the current system and displaces 50 percent of the cost of funding current benefits. By 2047 retirees would receive a full 20 percent investment bonus and their SI Account would fully fund their entire Social Security. Beyond 2047 any worker averaging $30,000 per year in real income will build up an SI Account that will fully fund his Social Security benefits.

Transition Costs and Benefits

Figure 5 shows the cost and benefits of transitioning from the existing, debt-based system into an investment-based Social Security system. The blue line in Figure 5 (with ▲s marking cost levels at five year intervals) shows the real cost (in 1998 dollars) required to fund the existing Social Security system through the year 2075. The red line in Figure 5 (with ●s
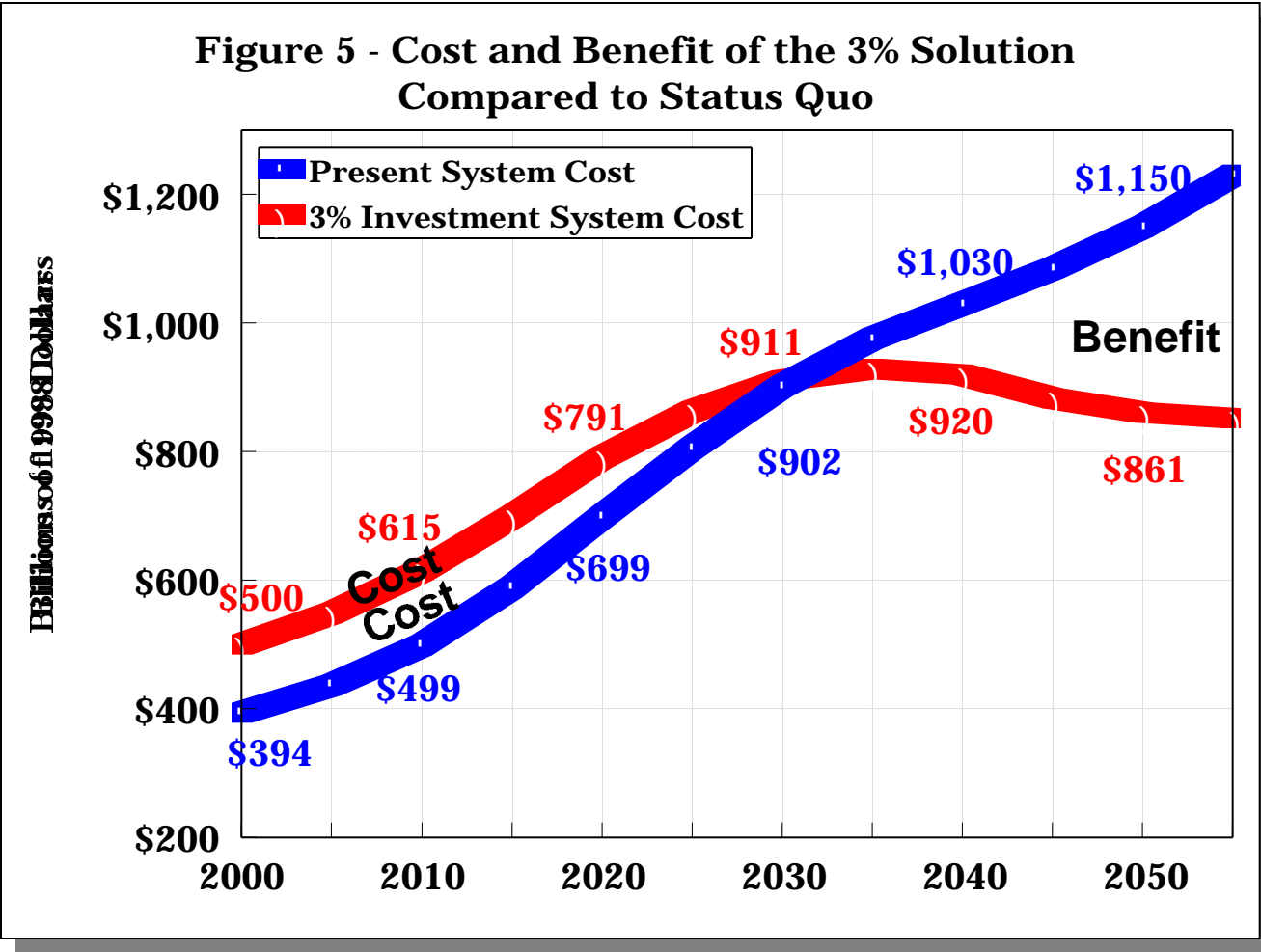
marking cost levels at five year intervals) shows the amount needed to fund the new investment-based system. In the year 2000, the existing Social Security system will cost $394 billion. To maintain that level of funding for the existing system and, at the same time, allow workers to invest three percent of wages in their SI Accounts will cost an additional $106 billion.

The cost of the existing Social Security system is slated to rise to $699 billion in 2020. By 2020, the investment-based system can allow a real investment of three percent of wages and still pay the benefits of the existing system with an additional $92 billion, since roughly 20 percent of all benefits to new retirees in that year will be paid for by investments they made over the previous twenty years. By the year 2031, the cost of the investment-based system is roughly the same as the $918 billion that would have been required to fund the existing system. By 2040, 80 percent of the benefits paid to new retirees would be paid for by the investments they have made over the previous 40 years and the earnings on those investments. In 2040 the cost of the existing system will have risen to $1,030 billion while the cost of the investment-based system would be $920 billion.

By the year 2050, the cost of the existing Social Security system would be $1,150 billion and rising, whereas the cost of the new investment-based system would be back down to $861 billion and falling. The retirement benefits of the average new retiree would be fully funded through his SI Annuity. The remaining cost of the old system would consist of paying benefits to people who had retired previously, paying minimum benefits to those whose SI

Annuities fall short of funding the guaranteed minimum, and paying survivor and other benefits.

Figure 5 shows the transition costs of moving to an investment-based system and the benefits of that transition. The transition cost is measured by the area between the blue line (▲s) showing the cost of maintaining the current Social Security system and the red line (●s)

## Figure 5 - Cost and Benefit of the 3% Solution Compared to Status Quo

**Present System Cost**
**3% Investment System Cost**

$1,150

$1,030

$1,000

**Benefit**

$911

$791

$920

$861

$615

$800

$902

$500

**Cost**
**Cost**

$699

$600

$499

$400

$394

$200

Billions of 1998 Dollars

2000    2010    2020    2030    2040    2050

showing the cost of an investment-based system. The transition cost is three percent of wages in 2000 and declines to zero in 2031. In each of these transition years, the cost of the new system would exceed the cost of the existing system, but as worker investments build up

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under the new system and begin to fund retirement benefits the transition cost falls off sharply. From the year 2031 on, the cost of the new system declines relative to the old system as real investments fund an even larger share of Social Security benefits. The cost of the existing system continues to rise because all benefits must be paid for with taxes on the wages of workers who are declining in number relative to the number of retirees. The benefits of moving to the new investment-based system through the year 2055 are shown as the area between the blue line (▲s) and the red line (●s) to the right of the break-even point in 2031. Clearly, over a time, the benefits of moving to an investment-based system greatly exceed the cost of making the transition.[9]

Funding the Transition to an Investment-based System

From the previous analysis it is clear that over any extended period substantial savings accrue as a result of instituting an investment-based system and harnessing the power of compound interest to pay future benefits. In that sense, when you look at a long period of time, there are no net transition costs in moving from the current debt-based system into an investment-based system. In fact, there are substantial savings. There is, however, a cash flow problem since the cost of moving into the investment-based system occurs in the first 31 years of implementation and the benefits flow in every year thereafter. Any serious proposal to institute an investment-based system for Social Security must contain a program to fund this cash flow problem.

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[9] When the net new corporate income taxes collected on SI Account investments are recaptured for use by Social Security, the cost of the investment-based system is reduced and the red line (●s) in Figure 5 pivots down clockwise lowering the transition cost and raising the benefits of changing the system.

Figure 6 shows the cash flow problem produced by transitioning to an investment-based system. The dotted line in Figure 6 shows the transition cost of allowing workers to invest three percent of wages in their individual SI Accounts. That cost is $106 billion in the year 2000. Over time, two forces drive the cost of the transition to an investment-based system.

**Figure 6 - Cash Flow Problem to Fund an Investment-Based System**
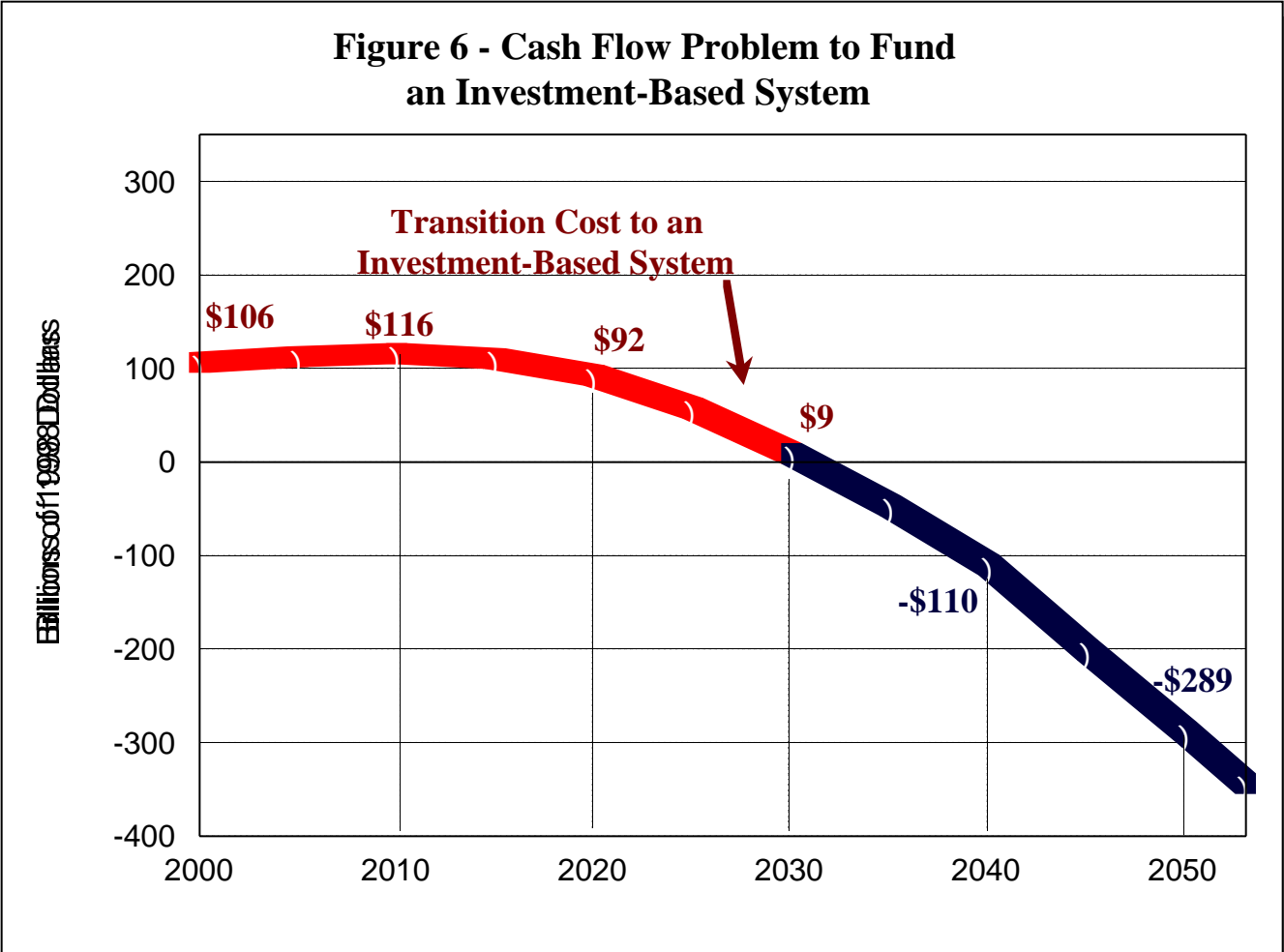


The first is the growth in the labor force and the growth in real wages which causes the three percent investment of wages to rise slightly in inflation-adjusted dollars. The second force is that as real investments build up over time, they pay more and more Social Security benefits

and thereby lower the transition costs.  As shown in Figure 6, the transition cost begins at $106 billion in 2000, rises to $116 billion in 2010 and falls to $92 billion in 2020.

By 2031 the build up of SI accounts is sufficient to fund a large enough share of total Social Security liabilities so that the benefits of the investment-based system fully offset the costs of the investment-based system. Therefore, in 2031 the funding of the transition to an investment-based Social Security system is complete.  By 2040, the investment-based system will generate a surplus of $110 billion in real, after-inflation dollars.  By 2050 that surplus would rise to $289 billion.

<u>Funding Both the Transition Cost and the Rising Cost of the Baby Boom Retirement</u>

The analysis in Figure 6 shows the magnitude of the transition cost to an investment-based system relative to the cost of maintaining the <u>status</u> <u>quo</u>, but it does not answer the all important question of how to fund the rising retirement cost built into the current system.  In fact, the <u>status</u> <u>quo</u> under the current system will require massive increases in the payroll tax or deep cuts in benefits or some combination of the two.
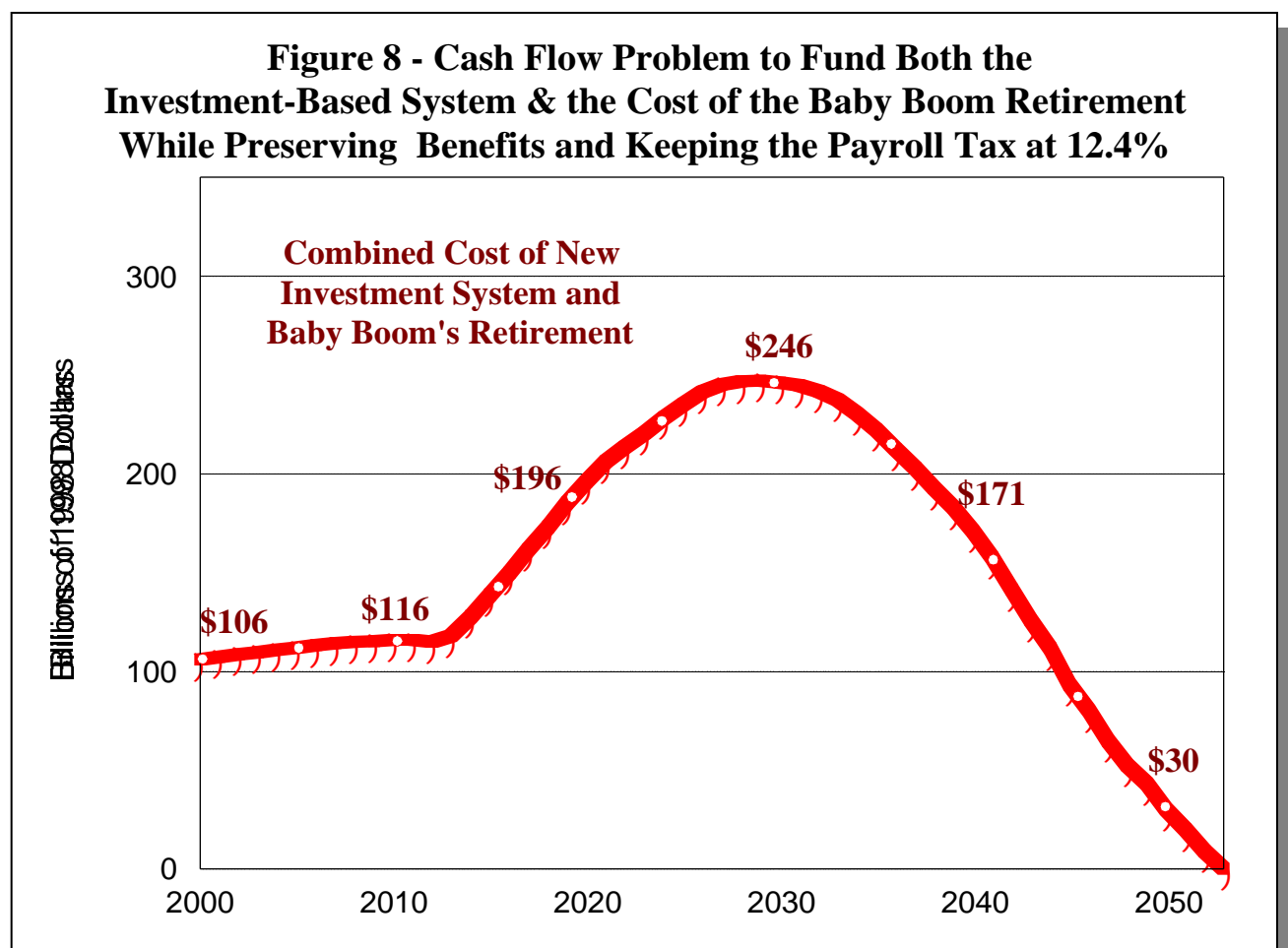
Figure 7 shows the funding gap faced by the current Social Security system if benefits are not cut and if the payroll tax is not increased. The funding gap appears in 2013 as the first wave of Baby Boomers starts to retire. By 2020 the funding gap will reach $104 billion. The funding shortfall of the current system rises to $237 billion in 2030, to $281 billion in 2040 and continues to rise on a permanent basis. If we are to fund the transition to an investment-

**Figure 7 - Cash Flow Problem to Fund the Rising Cost of Present System While Keeping the Payroll Tax at 12.4%**
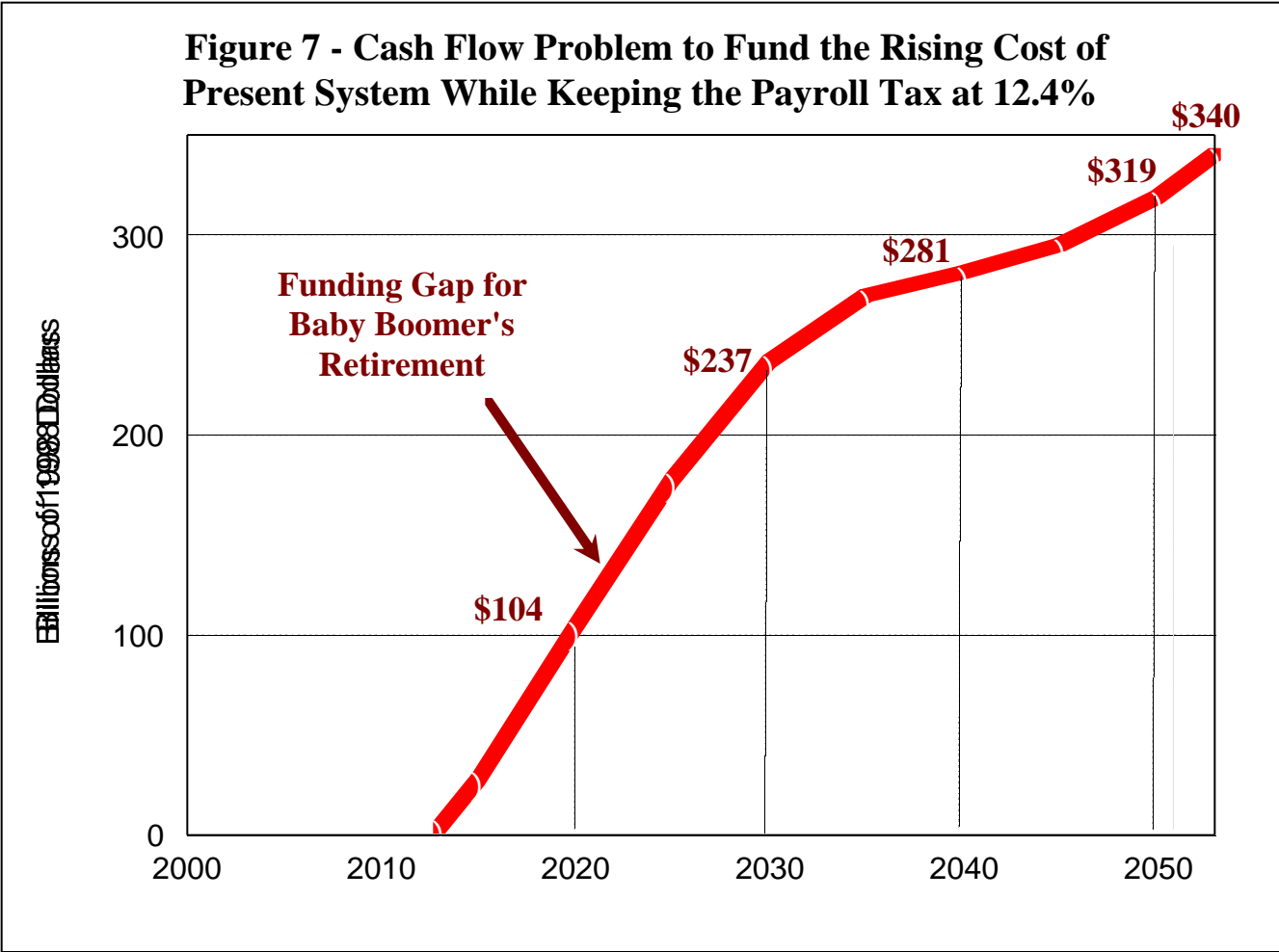


based system and fund the Baby Boom retirement cost built into the current system without either cutting benefits or raising payroll taxes, the total cash flow problem is the sum of

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Figures 6 and 7.[10]  Figure 8 shows the cash flow problem incurred in funding both the transition cost to an investment-based system and funding the cost of the Baby Boom retirement.

The total cost measured in after inflation dollars rises as total real wages rise and as the 77 million members of the Baby Boom generation make ever growing pension demands on the current Social Security system.  The total cost falls over time as the investment-based system pays for an ever increasing share of Social Security pension cost.  As shown in Figure 8, the



**Figure 8 - Cash Flow Problem to Fund Both the Investment-Based System & the Cost of the Baby Boom Retirement While Preserving  Benefits and Keeping the Payroll Tax at 12.4%**

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[10]  While this analysis seeks to show the feasibility of transitioning to an investment-based system without raising payroll taxes or cutting benefits, either action makes the achievement of a permanent solution easier.

total transition cost rises from $106 billion in 2000, to $116 billion in 2010, and to $246 billion by 2030. It falls sharply after 2030 as investment-based SI Annuities fund over 50 percent of Social Security benefits for new retirees. By 2053 the transition is complete and the investment-based Social Security system is in surplus.

**Figure 9 - Cash Flow Solution to Fund Both the Investment-Based System & Cost of Present System While Preserving Benefits and Keeping the Payroll Tax at 12.4%**
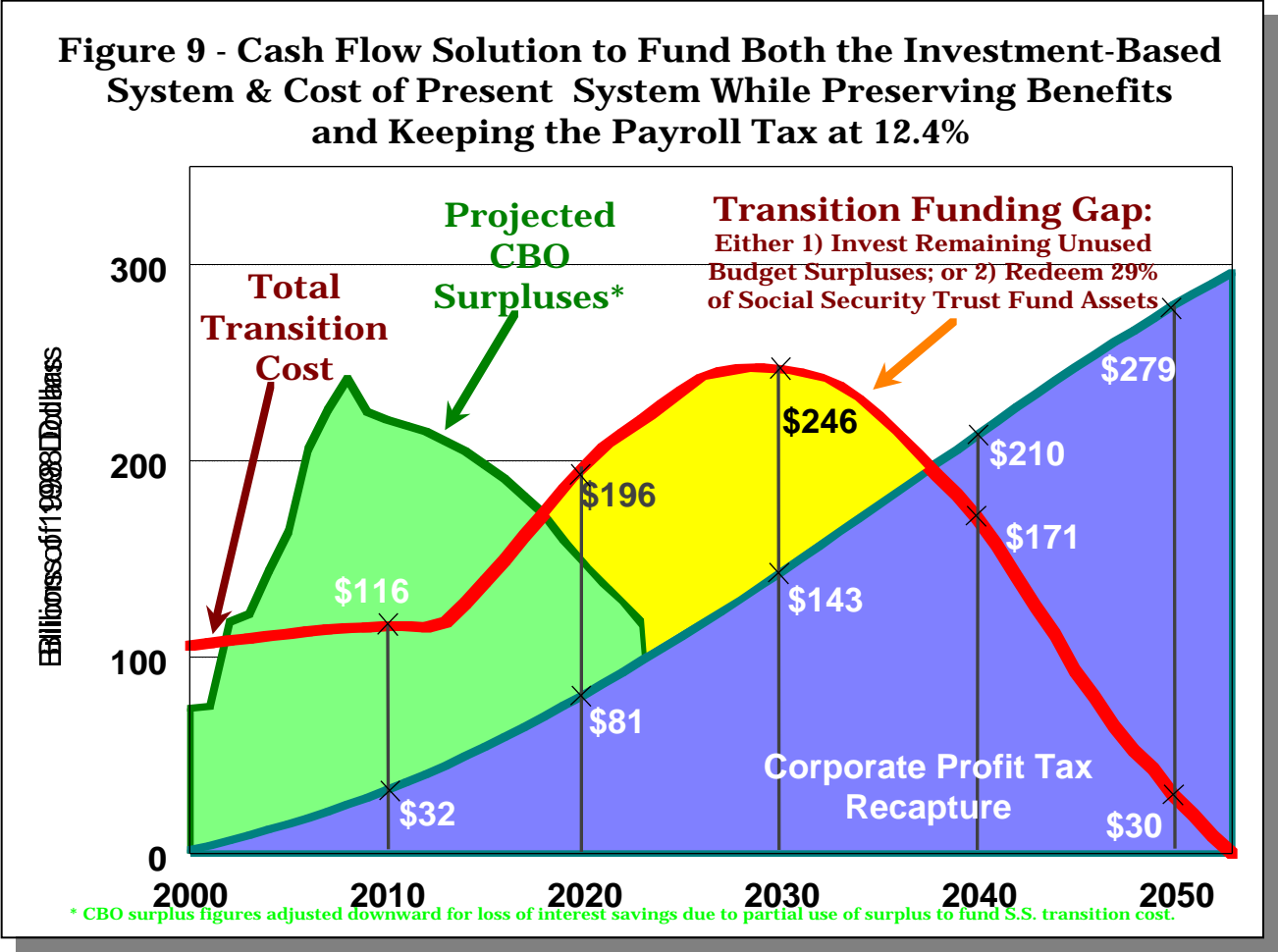


Figure 9 shows the total cash flow required to fund both the transition to an investment-based system and the cost of funding the Baby Boom retirement taken from Figure 8. The shaded areas of Figure 9 identify funding sources for the transition. Throughout the transition and thereafter, the Federal government will collect corporate profit taxes on the

earnings of investments funded by SI Accounts.  These are new revenues on new investment that would not exist except for the new investment-based Social Security system. Though small at first, Federal corporate tax collections on SI Account investments grow as the level of investment in SI Accounts build up.  The corporate profit tax recapture is shown in blue in Figure 9.  Recapturing Federal corporate profit taxes on SI Account investments for the Social Security system provides a funding source that grows from zero in 2000 to $81 billion by 2020, $143 billion in 2030 and $279 billion by 2050 as the level of SI Account investments build up to $3.9 trillion, $7 trillion and $13.7 trillion respectively.  Based on the assumption that 80 percent of the SI accounts are new investments, that 10 percent of the SI account investments leak into other countries and therefore escape U.S. corporate income taxes and that five percent escapes Federal corporate income taxes in subchapter S corporations and other leakage, the effective recapture rate would be 23.9 percent (down from the 35 percent corporate income tax rate).  At the end of each year based on the actual earnings of the total of all SI Accounts and the actual corporate income tax revenues collected, the Treasury will remit to the Social Security system that portion of corporate income tax revenues equal to 23.9 percent of total pre-tax SI Account earnings.

The Congressional Budget Office (CBO) now projects cumulative Federal budget surpluses of $2.2 trillion over the next decade.[11]  That surplus, which will persist until after 2020 but decline as the Baby Boom generation begins to retire, is shown in green in Figure 9.  The CBO projected surplus, when added to the corporate tax recapture, will fully fund the transition

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[11]  This number assumes an extension of the existing caps on discretionary spending.

cost to an investment-based Social Security system and the Baby Boom cost explosion through 2017. If the projected surpluses of $63 billion in FY 1998 and $80 billion in FY 1999 were impounded now and rolled into 2000 to help fund the transition, the CBO projected surplus would be even larger.

If only the portion of the budget surplus needed in each fiscal year to fund the transition were dedicated to that purpose, a total of $1.11 trillion be required. The remainder of the surplus could be used for other purposes. If the surplus above the amounts needed in each fiscal year to fund the transition were rolled forward to fund the transition in future years, the CBO surplus and the corporate income tax recapture alone would roughly fund the transition.

Assuming that only the portion of the annual surplus needed to fund the annual transition cost in each year is dedicated to that purpose, it will be necessary to require the Federal government to repay the Social Security Administration 29 percent of the money it has borrowed from the system since 1983 in order to fill the funding gap. That repayment, $1,594 billion, is shown in yellow in Figure 9. It would average roughly $84 billion per year over 19 years.[12]
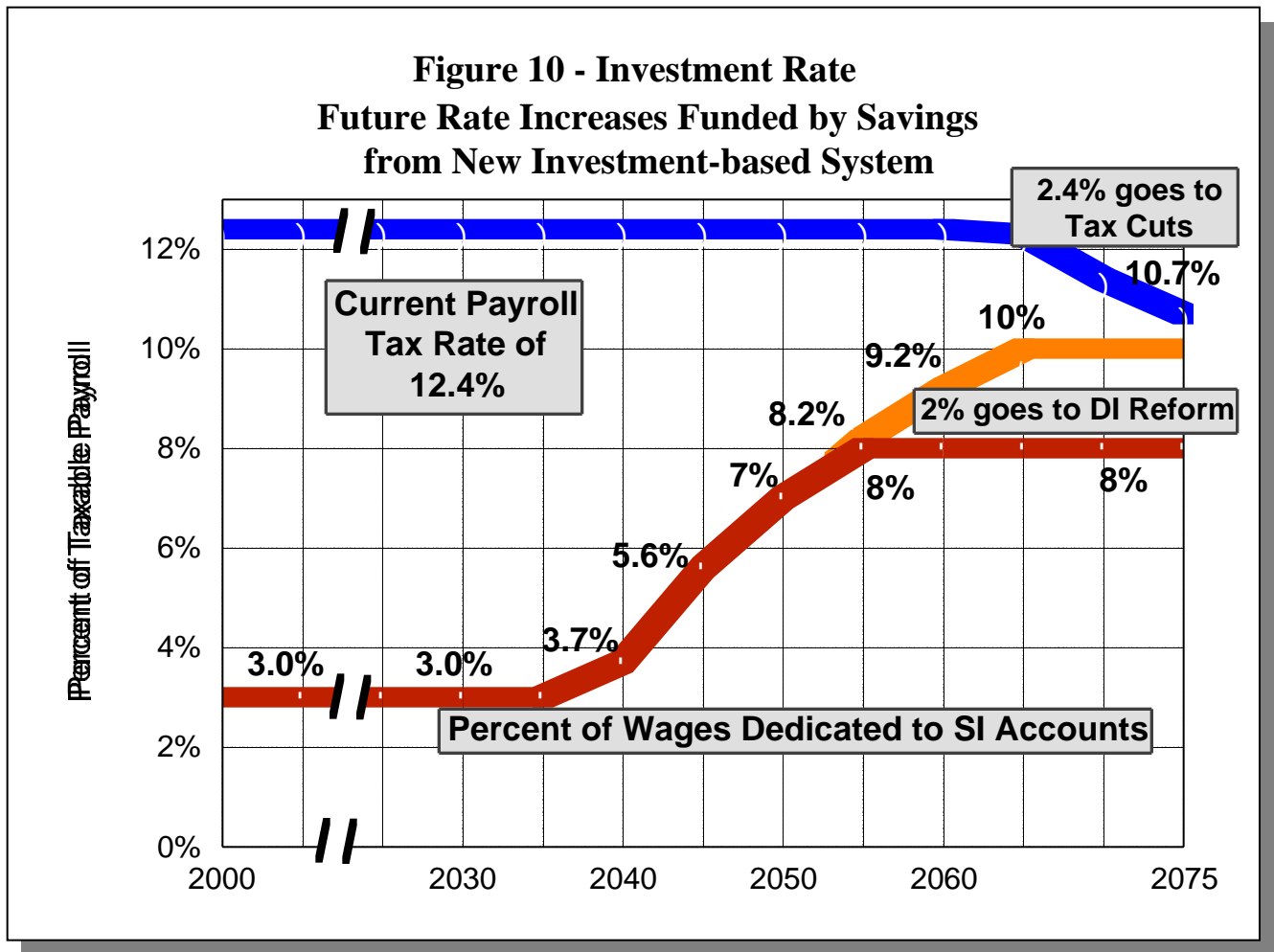
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[12] Since an investment-based system requires real investment, if the Federal government funds part of the transition by paying back 29 percent of what it has borrowed from the Social Security system, such funds must be obtained by spending cuts or tax increases. If the Federal government simply borrowed the money from the public, the funds going into the system would not be net new investment.

By using part of the projected CBO budget surpluses, redeeming 29 percent of the Social Security Trust Fund and recapturing the net new corporate profit taxes flowing to the Federal government from taxing Social Security investment income, we can fund both the transition cost and the built-in cost of the Baby Boom retirement explosion of the present system without cutting benefits or raising payroll taxes. By converting to an investment-based system now, the Baby Boom generation, which pays an incredible 60 percent of all payroll taxes today, still has time to build up SI Accounts to partially fund their Social Security benefits. If the investment-based system is initiated in 2000, the first Baby Boomers can still build up an SI Account that will fund almost 10 percent of their Social Security benefits in retirement. The last Baby Boomer, retiring after 2032, can still build up an SI Account that will fund roughly 50 percent of his Social Security benefits. If implementation of the investment-based system is delayed and the Baby Boom generation retires under the current system, tax increases and benefit cuts, under the best of circumstances, will be massive.

As shown in Figure 9, the investment-based Social Security system is self-financing by 2038. Therefore, beginning in 2038 the amount of the 12.4 percent payroll tax going into real investments can begin to rise above the initial three percentage point level. As shown in Figure 10, the percentage of wages flowing into real investments through SI Accounts can rise over time reaching its new level of eight percent around 2055. An additional two percent of payroll pays for disability insurance and the payroll tax rate can be reduced over time from 12.4 percent to 10 percent. When fully phased in by 2055, the rate of real investment will be eight percent of wages, yielding an expected basic pension level 2.5 times the level

provided by the current Social Security system for an average worker.  The payroll tax will

begin to decline after 2065 and reach the permanent level of 10 percent, thereby giving

**Figure 10 - Investment Rate**
**Future Rate Increases Funded by Savings**
**from New Investment-based System**

**2.4% goes to Tax Cuts**

**Current Payroll Tax Rate of 12.4%**

10.7%

10%

9.2%

8.2%

**2% goes to DI Reform**

7%

5.6%

8%

8%

3.7%

3.0%    3.0%

**Percent of Wages Dedicated to SI Accounts**

Percent of Taxable Payroll

12%

10%

8%

6%

4%

2%

0%

2000    2030    2040    2050    2060    2075

workers a 19 percent reduction in their Old Age Survivors and Disability Insurance (OASDI)

taxes.  To maintain the solvency of the current Social Security system after 2065, we would be

forced to raise the payroll tax by 48 percent or cut benefits by 33 percent.

Funding Family and Survivors Benefits

Today, spouses (including some former spouses) and dependent children of retired workers receive a family benefit equal to 50 percent of the retired worker's expected Social Security benefit.  At age 65, surviving spouses receive 100 percent of the deceased worker's expected Social Security benefit, with lower amounts paid to younger surviving spouses, dependent children, and dependent parents.  The total amount of benefits paid to all family members is capped at 188 percent of the retired worker's base benefit, with additional amounts available for divorced spouses who were married to the retired worker for at least ten years.  Upon the worker's death, the surviving spouse or children receive a one-time, lump sum death benefit of $255.  Also, family and survivor benefits are reduced dollar for dollar by the amount of Social Security benefits earned in the spouse's or child's own name.

These benefits will continue to be paid under the new system, but the source of funding will gradually change.  After the percentage of the payroll tax dedicated to SI Accounts has risen to five percent, the SI Annuity purchased at retirement will begin to cover part of the cost of family and survivor benefits.  When new workers are contributing at least seven percent of their wages to their SI Account throughout their working lives, their SI Annuity will fully fund these benefits upon retirement.  Any shortfall in these benefits will continue to be financed by the Social Security system.  If the worker dies prior to retirement, his SI Account, minus the present value of the family and survivor benefits to be paid to his family by the existing Social Security system, is given to his heirs in a lump sum free of any taxes.

<u>Freedom to Retire</u>

In order to control the cost of Federal retirement programs, the government has established the retirement age for workers. When the Social Security system edged toward bankruptcy in the late 1970s, the government responded in 1983 by gradually increasing the retirement age to 67.  Similar proposals abound to respond to Social Security's current crisis by raising the retirement age to 70.

Under a fully implemented investment-based system, the worker rather than government will choose when to retire.  Workers could choose to retire at any age once they have built up a large enough SI Account to fund benefits equal to 120 percent of the Social Security benefit promised at the normal retirement age and fund any survivors, spousal or other benefits that might be triggered by their retirement.

Nothing in the investment-based Social Security system will alter the rules governing early retirement at age 62 under the current system.  Those workers who choose to participate in the investment-based system will have the right to retire at 62 with a benefit during the transition at least equal to their early retirement benefit under the current system plus 20 percent of their SI Fund.

## Disability Insurance

All new workers who enter the labor force after the year 2055 will transition into a new Cooperative Disability Insurance System. The Cooperative Disability Insurance System will be a private cooperative owned by workers and run by private insurance companies under the supervision and regulatory oversight of a Disability Insurance (DI) Board. The DI Board will be composed of the Secretary of Labor, the Secretary of the Treasury, a state insurance commissioner and two outside members who are experts in disability insurance, one of whom will be chairman. The two outside experts and the state insurance commissioner will be nominated by the President and confirmed by the Senate to staggered, six-year terms.

## Conclusion

America is about to enter a new millennium. While the promise of that new era seems secure for the first decade, increasing uncertainty hangs over every year thereafter. That uncertainty is the burgeoning cost of entitlements that begins when the Baby Boom generation starts to retire. Social Security's bankruptcy won't be just a financial crisis, it will be a human tragedy, not unlike the turmoil of the Great Depression.

After all the revenue projections, demographics and benefit calculations, the funding crisis of Social Security under the status quo boils down to two bad choices: America will have to choose between lost opportunity for our children and abandoned security for our parents.

If we choose the path of higher taxes, a tax rate that was two percent on our parents will be 18.4 percent for our children.  With Medicare, the payroll tax will almost certainly exceed 30 percent.

Choosing higher taxes means our children's and grandchildren's future will be marked by crumpled resumes, rejection notices and pink slips.  It will be jobs they hoped for but didn't get, raises they needed but were denied and advancements they earned but couldn't achieve.

If we choose the path of reduced benefits, retirement benefits will be cut by a third or more. That path means our parents' future will consist of discarded financial plans, harassing calls from bill collectors and penny-pinching at the grocery store. It will be dream vacations canceled, deserved retirements delayed and favorite hobbies and activities abandoned.

Think about American families in which two of our most powerful human emotions are pitted against each other: the desire to do anything to help our children get ahead and the determination to provide security and dignity for retired parents.

Children versus parents, grandchildren versus grandparents, the dreams of our children versus the security of our parents -- this is what the battle for Social Security will entail.  And it will be waged by real people through sleepless nights of worry, around kitchen tables where, despite boundless imagination and ingenuity, the pencils, papers and calculators of

breadwinners cannot navigate the barriers erected by government policies which, however well intended, are failing.

There is a better way.  It requires doing what Social Security promised but never delivered.  It requires that we employ one of the fundamental principles outlined by Franklin Roosevelt for Social Security: "Compulsory contributory annuities which in time will establish a self-supporting system for those now young and for future generations." It requires that we do what the Finance Committee chairman, Senator Pat Harrison, called for in the original Social Security debate when he said, "...the annuity system will give to the worker the satisfaction of knowing that he himself is providing for his old age."  It requires that we save and invest now rather than tax and borrow later.  But it is not just money at stake here.  Save today and we save our children's dreams tomorrow.  Invest today and we invest in our parents' security.   Tax tomorrow and we diminish our children's future, cut benefits tomorrow and we harden our parents' retirement.